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No. 90-1943

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1991

In re

PRUDENTIAL LINES, INC.,

Debtor.

PSS STEAMSHIP COMPANY, INC.,

Petitioner,

against

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS,

and

COLD SPRING SHIPPING, L.P.,

Respondents.

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	Page
TABLE OF AUTHORITIES	ii
CONCLUSION	10
APPENDICES	
APPENDIX A — 26 U.S.C. § 269(a)	1a
APPENDIX B — Treas. Reg. § 1.1502-12(h)	2a
APPENDIX C — Treas. Reg. § 1.1502-21(b)	3a
APPENDIX D — Treas. Reg. § 1.1502-77(a)	5a

TABLE OF AUTHORITIES

Page

A. Cases

In re Gull Air Inc., 890 F.2d 1255 (1st Cir. 1989) 9

In re Kendrick & King Lumber, Inc., 14 B.R. 764 (Bankr. W.D. Okla 1981) 4

Kokoszka v. *Belford*, 417 U.S. 642 (1974) 4

Pension Benefit Guaranty Corp. v. *Braniff Airways, Inc.* (*In re Braniff Airways, Inc.*), 700 F.2d 935 (5th Cir. 1983) 8, 9

Russell v. *United States* (*In re Russell*), 927 F.2d 413 (8th Cir. 1991) 5

Segal v. *Rochelle*, 382 U.S. 375 (1966) ..... *passim*

Union Electric Co. of Mo. v. *United States*, 305 F.2d 850, 158 Ct. Cl. 479 (1962) 7

United States v. *Whiting Pools, Inc.*, 462 U.S. 198 (1983) ... 3

Western Pacific Railroad Corp. v. *Western Pacific Railroad Co.*, 197 F.2d 994 (9th Cir. 1951), *reh'g denied*, 197 F.2d 1012, *vacated & remanded*, 345 U.S. 247, *prior opinion aff'd*, 206 F.2d 495 (9th Cir.), *cert. denied*, 346 U.S. 910 (1953), *reh'g denied*, 346 U.S. 940 (1954) .... *passim*

B. Statutes

14 C.F.R. § 93.221 9

U.C.C. § 9-106 4

11 U.S.C. § 105 2

11 U.S.C. § 110 4

11 U.S.C. § 346 ..... *passim*

11 U.S.C. § 541 ..... *passim*

	Page
11 U.S.C. § 728	6
11 U.S.C. § 1146	6
26 U.S.C. § 165	2, 6
26 U.S.C. § 269	4
26 U.S.C. § 382	2, 4, 8
26 U.S.C. § 1399	7
26 U.S.C. § 1501	2, 6
26 U.S.C. § 1502	2, 6
26 U.S.C. § 1503	2, 6
26 U.S.C. § 1504	2, 6

C. Legislative Reports, Regulations and Revenue Rulings

Committee on the Judiciary, United States Senate, to accompany S.2266, S. Rep. No. 989, 95th Cong., 2d Sess. 45-46 (1978)	6
124 Cong. Rec. H. 11087, H. 11096 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards)	5
H.R. Rep. No. 595, 9th Cong. 1st Sess. 176 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963	3
H.R. Rep. No. 595, 95th Cong., 1st Sess. 176 (1977), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6136	3
Prop. Treas. Reg. § 1.1502-20(g)(1)-(2)	8
Treas. Reg. § 1.1502-12(h)	7, 8
Treas. Reg. § 1.1502-21(b)	7, 8
Treas. Reg. § 1.1502-77(a)	7

	Page
Treas. Reg. § 1.167(a)-3	4
Treas. Reg. § 1.167(a)-6	4

D. Other Authorities

Black's Law Dictionary (6 ed. 1990)	4

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STATUTES INVOLVED

11 U.S.C. § 346—Petitioner's Appendix (P. App.) 81a

11 U.S.C. § 541—P. App. 84a

26 U.S.C. § 165—P. App. 88a

26 U.S.C. § 269—Petitioner's Reply Appendix 1a

26 U.S.C. § 382—Respondent's Appendix 4a

Respondents assume the legal conclusion they wish this Court to reach by repeatedly referring to the federal tax benefit associated with the NOL carryforward here in issue as a "valuable asset" of PLI. *See, e.g.*, Brief of Respondents in Opposition at 2, 6. As discussed at length in the Petition, the consolidated return provisions of the Internal Revenue Code, 26 U.S.C. §§ 1501-1504, the regulations promulgated under them, and the cases construing them, dictate that an NOL carryforward is not an "asset" of the subsidiary that generated it, but a tax attribute of the consolidated return controlled by the corporate parent. The Bankruptcy Code does not give a bankruptcy court the power to ignore this federal tax doctrine by declaring an NOL carryforward generated by a subsidiary to be its "asset" or "property" simply because that subsidiary is under the protection of the bankruptcy court.

Respondents urge that the *Western Pacific* line of cases cited at pp. 12-15 of the Petition are inapposite because they were decided under state law and predated the broader definition of "property" in section 541 and the treatment of NOLs in section 346 of the Bankruptcy Code. Respondents assert that these two sections, when read with the section describing a bankruptcy court's general powers (11 U.S.C. § 105), provide bankruptcy courts with sufficient authority to enjoin a non-bankrupt corporate parent from taking a worthless stock deduction under 26 U.S.C. § 165 since doing so would, because of 26 U.S.C. § 382, limit the availability of an NOL carryforward generated by a

bankrupt subsidiary. Neither section 541 nor section 346 of the Bankruptcy Code, however, provides such authority, since: neither provision makes the NOL carryforward the debtor's "property," neither provision nullifies the consolidated return regulations (which allocate control of NOLs to the corporate parent even if the subsidiary that generated the NOL is in bankruptcy), and neither provision empowers a bankruptcy court to enjoin a non-bankrupt from taking a worthless stock deduction. The case should be governed entirely by the Internal Revenue Code, which recognizes *no rights whatsoever* on the part of a bankrupt subsidiary with respect either to a non-bankrupt parent's right to take the benefit of an NOL carryforward generated by a bankrupt subsidiary, or its right to take a worthless stock deduction with respect to its lost investment in that subsidiary.

Section 541. In arguing that the Court of Appeals correctly construed "property" in 11 U.S.C. § 541 to include the NOL carryforward, respondents rely on legislative history to the effect that "property" includes:

> all interests, such as interests in real or personal property, tangible and intangible property, choses in action, causes of action, rights such as copyrights, trade-marks, patents, and processes, contingent interests and future interests, whether or not transferable by the debtor.

Brief at 8 n. 7 *quoting* H.R. Rep. No. 595, 95th Cong., 1st Sess. 176 (1977), *reprinted* in 1978 U.S. Code Cong. & Admin. News 5963, 6136. Respondents also cite this Court's conclusion in *United States* v. *Whiting Pools, Inc.*, 462 U.S. 198, 204-5 (1983) that section 541(a)(1)'s language ("all legal or equitable interests of the debtor in property as of the commencement of the case") is to be read broadly. If, however, Congress indeed intended NOL carryforwards (or a variety of other tax attributes) to be "property," or if it intended the Internal Revenue Code not to apply to corporate NOL carryforwards on consolidated returns once the subsidiary that generated them becomes bankrupt, why did Congress not say

so? Further, following this Court's differentiation of carryforwards and carrybacks in *Segal* v. *Rochelle*, 382 U.S. 375 (1966), why did Congress say that it was adopting *Segal* on "carrybacks," making "refunds" property of the estate, rather than say it was expanding *Segal* to cover NOL carryforwards on corporate consolidated returns? See Petition at 19 & n.13.[1] Tax attributes are not mentioned in the text of section 541, nor do they reasonably fit within the definitions of any of the terms in the legislative history of section 541 upon which respondents rely.[2]

Respondents admit that *Segal* did not involve corporations, but nevertheless they assert that "there is no reason to believe that the Court would have had any misgivings about treating carryforwards as property of a corporate debtor." Brief at 10. Without belaboring whether the *Segal* Court would or would not have had "misgivings" about extending its rationale to corporate taxpayers and to carryforwards (much less, to consolidated returns), the plain fact is that neither this Court, nor any other court, nor Con-

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[1] Carryforwards may be readily distinguished from carrybacks, which have been repeatedly construed to constitute a refund check from the IRS. As such, a carryback is no longer a "tax attribute" at all, but an "intangible" within the meaning of U.C.C. § 9-106. *See In re Kendrick & King Lumber, Inc.*, 14 B.R. 764 (Bankr. W.D. Okla. 1981) (*quoting* 11 U.S.C. § 541's legislative history to the effect that "property includes intangibles and the right to a refund under *Segal*)." *See also* Petition at 18-19. Like Congress, this Court itself described *Segal* as holding "that a business-generated loss carry*back* tax *refund*—which was based on prebankruptcy losses but received after bankruptcy—should pass to the trustee as . . . property." *Kokoszka* v. *Belford*, 417 U.S. 642, 646-47 (1974), citing section 70(a)(5) of the (then) Bankruptcy Act, 11 U.S.C. § 110(a)(5) (emphasis supplied).

[2] *See, e.g.*, Black's Law Dictionary (6th ed. 1990) defining "Intangible property," "Intangibles," and "Intangible asset." *See also* U.C.C. § 9-106. It is obviously a violation of the Internal Revenue Code to "traffic" in tax benefits as if they were property. *See generally* 26 U.S.C. §§269(a), 382. Clearly no such prohibition exists with respect to intangibles. And one would be fairly shocked to see future tax benefits described as having a "basis" or as being "amortized" or "depreciated," while intangibles clearly may be. *See* Treas. Reg. §§ 1.167(a)-3; 1.167(a)-6 (1991). Tax benefits are similarly to be strictly differentiated from the "rights" (copyrights, trade-marks, patents, e.g.) listed in the legislative history of 11 U.S.C. § 541.

gress in drafting section 541 and in codifying *Segal* into section 346, has ever made such extensions. PSS urges that the Court of Appeals was incorrect in doing so.[3] As discussed at pp. 17-21 of the Petition, when Congress codified *Segal*, it did *not* expand "property" in 11 U.S.C. § 541 to include NOL carryforwards, nor did it address how members of an affiliated group should allocate tax attributes on consolidated corporate returns. Instead, it added a subsection to 11 U.S.C. § 346, which provides a set of bankruptcy exceptions to the Internal Revenue Code. That subdivision addresses only what *Segal* addressed: an "individual" debtor. The legislative history plainly states that subdivision (i) "codifies the law of *Segal* . . . on carry*backs*" (emphasis supplied), just as the legislative history of section 541 states that the Code codifies *Segal* and makes "refunds" property of the debtor. *See* Petition at 19 & n.13. One may not simply ignore these words in the statute and its legislative history and construe subsection (i) to apply to corporations, much less to corporations filing consolidated corporate returns in which only the subsidiary is in bankruptcy.[4] That constitutes an unwarranted construction of subdivision (i) and a radical extension of *Segal*.

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[3] Respondents cite *Russell* v. *United States* (*In re Russell*), 927 F.2d 413, 417-18 (8th Cir. 1991) as authority for their position. *Russell*, however, like *Segal*, concerned an individual debtor, not a corporation. It should also be noted that the only authority cited by the *Russell* court for the proposition that an NOL carryforward is "property" for purposes of section 541 is the Bankruptcy Court's decision in *this* case.

[4] Thus, even if section 346(i) *did* apply to corporations and *did* equate tax attributes with "property," it would still not apply in a consolidated return case because the "tax attributes" referred to therein are not the subsidiary's but the parent's. As the legislative history states, while the estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case," it is also true that "[t]o the extent such interest is limited in the hands of the debtor, it is equally limited in the hands of the estate." 124 Cong. Rec. H. 11087, H. 11096 (daily ed. Sept. 28, 1978) (remarks of Rep. Don Edwards). As the *Western Pacific* cases make clear, since at the commencement of PLI's bankruptcy PSS had breached no fiduciary or contractual duty to PLI to provide the tax benefit of PLI's losses to PLI, the latter had no cognizable interest in such benefits.

Footnote continued on next page

With no other authority for the view that either section 541 or section 346(i) renders this NOL carryforward PLI's "property," respondents rely upon 11 U.S.C. § 346(h) and (j) and assert, based upon their readings of these two subsections: "*It could hardly be clearer* that the Bankruptcy Code contemplates that NOL carrybacks and carryforwards are *property* of the estate of a corporate debtor." Brief at 12 (emphasis supplied). This sweeping conclusion is insupportable for several reasons. First, a reading of section 346 as a whole (and of subsection (i) specifically) makes clear that Congress did *not* refer to NOL carryovers as "property," but rather as one of several "tax attributes" that result from a variety of tax-triggering transactions in "property." *See, e.g.*, subsections (g)(1) and (i)(1). "Tax attributes," that is, are clearly differentiated from "property" in section 346, rendering it impermissible—on this ground alone—to silently bootstrap NOL carryforwards back into section 541 as an "interest in property."

Nor do subsections (h) and (j) support respondents' suggested extension of *Segal* to apply to corporate taxpayers. The legislative history states, in relevant part:

> Subsection (h) provides that the creation of *the estate of an individual* under chapter 7 or 11 of title 11 as a separate taxable entity does not affect the number of taxable years for purposes of computing loss carryovers or carrybacks.

Committee on the Judiciary, United States Senate, to accompany S.2266, S. Rep. No. 989, 95th Cong., 2d Sess. 45-46 (1978) (emphasis supplied).[5] And subsection (j) deals solely with issues of State and local tax law.

Finally, section 346(a) expressly provides that *all* of section 346 is "subject to the Internal Revenue Code," including, presumably, the provisions regarding consolidated returns (26 U.S.C. §§ 1501-1504), the provision regarding worthless stock deductions (26 U.S.C. § 165), and the provision indicating that a cor-

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[5] Subsection (h) cross-references two other provisions, 11 U.S.C. §§ 728(a) and 1146(a) (1990), both of which deal solely with individual debtors.

poration is not treated differently for tax purposes because of its bankruptcy (26 U.S.C. § 1399).

Thus, nothing in section 346 provides support for the conclusion urged by respondents: that the section authorizes a bankruptcy court to declare the federal tax benefit of a corporate NOL carryforward generated by a bankrupt member of a consolidated group to be that member's "property" because it is in bankruptcy. It is the consolidated return regulations promulgated under the Internal Revenue Code,[6] and not the Bankruptcy Code, that apply to this NOL carryforward, and they allocate the benefit of that tax attribute to PSS, not PLI. *See* Treas. Reg. §§ 1.1502-77(a); 1.1502-21(b); 1.1502-12(h).

While respondents urge that the *Western Pacific* line of cases deal solely with state law, they in fact squarely hold, in the context of the bankruptcy of one member of a consolidated group:

> There is nothing in the [Internal Revenue] Code or Regulations that compels the conclusion that a tax saving must or should inure to the benefit of . . . the company which has sustained the loss that makes possible the tax savings.[7]

A parent of a consolidated group is not obliged—under either fiduciary or tax principles—to give to a subsidiary the benefit of an NOL carryforward that it generated, despite the latter's bankruptcy.[8] There is simply no provision in the Bankruptcy Code rendering the consolidated return provisions inapplicable in the bankruptcy context.

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[6] These regulations are "legislative in character" and "have the force and effect of law." *Union Electric Co. of Mo.* v. *United States*, 305 F.2d 850, 854, 158 Ct. of Cl. 479, 486 (1962) (citing authority).

[7] This passage, from *Western Pacific*, 197 F.2d at 1003-4, is quoted as authoritative in most of the opinions cited at page 14 of the Petition.

[8] As stated in *Western Pacific*: " 'the fact that one subsidiary contributes a particular income deduction to a consolidated return does not in itself entitle that subsidiary to the benefits of the reduced taxes resulting from the deduction . . . .' " See Petition at 13.

The parties also disagree on how the consolidated return regulations work. Respondents assert (at 6-7 n. 7) that those regulations allocate NOL carryforwards to the subsidiaries that generated them. This is plainly incorrect as a matter of law. First, respondents' primary authority for this novel suggestion is a proposed regulation, Prop. Treas. Reg. § 1.1502-20(g)(1)-(2), which was not in effect during the time period relevant herein. The tax benefit of an NOL carryforward generated by a subsidiary member of a consolidated group is automatically allocated to the common parent when the parent or the other members of the group have earned taxable income against which that NOL may be offset. Treas. Reg. §§ 1.1502-21(b); 1.1502-12(h). Thus, consistent with the regulation and with the *Western Pacific* cases construing the predecessor of this regulation, the NOL generated by PLI (which itself had no income) is available to PSS to offset income recognized by PSS or any other member of the consolidated group.

Respondents (at 7-8) also find support in 26 U.S.C. § 382 (*l*)(5). That provision, however, is not an exception to the consolidated return regulations, and does not address in any way how any competing claims for the NOL should be allocated among creditors and members of the consolidated group of which the debtor was a member. Clearly Congress could have provided for such an allocation, but it did not. Again, absent a clear direction from Congress that a special rule should apply in the bankruptcy context, the corporate tax provisions of the Internal Revenue Code apply.

Nor does it add anything to suggest (as respondents do at 9 n. 11) that another benefit of comprehensive congressional regulation, gate slots at airports, have been held by some courts to constitute "property" within the ambit of section 541. As pointed out at pp. 23-24 of the Petition, the court in *Pension Benefit Guaranty Corp.* v. *Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935 (5th Cir. 1983) held that advantageous gate slots were *not*

"property" for bankruptcy purposes (at least at the time *Braniff* was decided) because they were merely an incidental (albeit a substantial and fully liquidated) benefit of federal regulation. The court in the later *In re Gull Air Inc.*, 890 F.2d 1255 (1st Cir. 1989) held gate slots to be no longer just a non-property "privilege" *because* (following a change in the applicable federal regulation in 1986) they constituted a "license" issued by the federal government that could (like "intangibles") be "bought, sold or leased for any consideration . . . ." *Id.* at 1260, *quoting* 14 C.F.R. § 93.221(a) (1989). The plain fact remains, however, that tax benefits may still not be bought and sold. *See* note 2 above. They thus constitute the greatest example of the same phenomenon presented by airport gate slots prior to 1986: an incidental (but non-"property") benefit to private parties resulting from comprehensive federal regulation.

Finally, in answer to PSS's assertion that the Bankruptcy Court had no jurisdiction, respondents rely upon the Court of Appeals' unprecedented conclusion that a bankruptcy court has jurisdiction to enjoin a non-bankrupt parent corporation from taking a worthless stock deduction with respect to its investment in a bankrupt subsidiary if doing so "interferes" with the tax benefit of an NOL carryforward, since that tax benefit constitutes the subsidiary's "property." This view prevails only if this Court construes this NOL carryforward to be PLI's "property" within the meaning of sections 541 and/or 346, and then further holds that a non-bankrupt unlawfully interferes with such "property," within the meaning of the automatic stay provision of the Bankruptcy Code (section 362), by filing a federal tax return which includes a tax deduction (here, a worthless stock deduction) which clearly is *not* the debtor's "property." PSS is under no legal obligation to "elect" foregoing the $38.9 million tax benefit arising from its long-term investment in PLI, in order to give PLI the tax benefit of an NOL carryforward that *itself* belongs not to PLI but to PSS.

CONCLUSION

Petitioner respectfully requests that the Court grant the Petition.

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APPENDICES

APPENDIX A

26 U.S.C. § 269(a)

§ 269. Acquisitions made to evade or avoid income tax

(a) In general.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation, and the principal purposes for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

APPENDIX B

Treas. Reg. § 1.1502-12(h)

Separate taxable income.

The separate taxable income of a member (including a case in which deductions exceed gross income) is computed in accordance with the provisions of the Code covering the determination of taxable income of separate corporation, subject to the following modifications:

* * *

(h) No net operating loss deduction shall be taken into account;

APPENDIX C

Treas. Reg. § 1.1502-21(b)

Consolidated net operating loss deduction.

* * *

(b) *Consolidated net operating loss carryovers and carrybacks*—(1) *In general.* The consolidated net operating loss carryovers and carrybacks to the taxable year shall consist of any consolidated net operating losses (as determined under paragraph (f) of this section) of the group, plus any net operating losses sustained by members of the group in separate return years, which may be carried over or back to the taxable year under the principles of section 172(b). However, such consolidated carryovers and carrybacks shall not include any consolidated net operating loss apportioned to a corporation for a separate return year pursuant to paragraph (a) of § 1.1502-79, and shall be subject to the limitations contained in paragraphs (c), (d), and (e) of this section and to the limitation contained in § 1.1502-15.

(2) *Rules for applying section 172(b)(1)-(i) Regulated transportation corporations.* For purposes of applying section 172(b)(1)(C) (relating to net operating losses sustained by regulated transportation corporations), in the case of a consolidated net operating loss sustained in a taxable year for which a member of the group was a regulated transportation corporation (as defined in section 172(j)(1)), the portion, if any, of such consolidated net operating loss which is attributable to such corporation (as determined under paragraph (a)(4) of § 1.1502-79) shall be a carryover to the sixth taxable year following the loss year only if such corporation is a regulated transportation corporation for such sixth year, and shall be a carryover to the seventh taxable year following the loss year only if such corporation is a regulated transportation corporation for both such sixth and seventh years.

Appendix C

(ii) *Trade expansion losses.* In the case of a carryback of a consolidated net operating loss from a taxable year for which a member of the group has been issued a certification under section 317 of the Trade Expansion Act of 1962 and with respect to which the requirements of section 172(b)(3)(A) have been met, section 172(b)(1)(A)(ii) shall apply only to the portion of such consolidated net operating loss attributable to such member.

(iii) *Foreign expropriation losses.* An election under section 172(b)(3)(C) (relating to 10-year carryover of portion of net operating loss attributable to a foreign expropriation loss) may be made for a consolidated return year only if the sum of the foreign expropriation losses (as defined in section 172(k)) of the members of the group for such year equals or exceeds 50 percent of the consolidated net operating loss for such year. If such election is made, the amount which may be carried over under section 172(b)(1)(D) is the smaller of (a) the sum of such foreign expropriation losses, or (b) the consolidated net operating loss.

(3) *Absorption rules.* For purposes of determining the amount, if any, of a net operating loss (whether consolidated or separate) which can be carried to a taxable year (consolidated or separate), the amount of such net operating loss which is absorbed in a prior consolidated return year under section 172(b)(2) shall be determined by:

(i) Applying all net operating losses which can be carried to such prior year in the order of the taxable years in which such losses were sustained, beginning with the taxable year which ends earliest, and

(ii) Applying all such losses which can be carried to such prior year from taxable years ending on the same date on a pro rata basis, except that any portion of a net operating loss attributable to a foreign expropriation loss to which section 172(b)(1)(D) applies shall be applied last.

APPENDIX D

Treas. Reg. § 1.1502-77(a)

Common parent agent for subsidiaries.

(a) *Scope of agency of common parent corporation.* The common parent, for all purposes (other than the making of the consent required by paragraph (a)(1) of § 1.1502-75, the making of an election under section 936(e), the making of an election to be treated as a DISC under § 1.992-2, and a change of the annual accounting period pursuant to paragraph (b)(3)(ii) of § 1.991-1) shall be the sole agent for each subsidiary in the group, duly authorized to act in its own name in all matters relating to the tax liability for the consolidated return year. Except as provided in the preceding sentence, no subsidiary shall have authority to act for or to represent itself in any such matter. For example, any election available to a subsidiary corporation in the computation of its separate taxable income must be made by the common parent, as must any change in an election previously made by the subsidiary corporation; all correspondence will be carried on directly with the common parent; the common parent shall file for all extensions of time including extensions of time for payment of tax under section 6164; notices of deficiencies will be mailed only to the common parent, and the mailing to the common parent shall be considered as a mailing to each subsidiary in the group; notice and demand for payment of taxes will be given only to the common parent and such notice and demand will be considered as a notice and demand to each subsidiary; the common parent will file petitions and conduct proceedings before the Tax Court of the United States, and any such petition shall be considered as also having been filed by each such subsidiary. The common parent will file claims for refund or credit, and any refund will be made directly to and in the name of the common parent and will discharge any liability of the Government in respect thereof to any

such subsidiary; and the common parent in its name will give waivers, give bonds, and execute closing agreements, offers in compromise, and all other documents, and any waiver or bond so given, or agreement, offer in compromise, or any other document so executed, shall be considered as having also been given or executed by each such subsidiary. Notwithstanding the provisions of this paragraph, any notice of deficiency, in respect of the tax for a consolidated return year, will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice of deficiency as to the other members); any notice and demand for payment will name each corporation which was a member of the group during any part of such period (but a failure to include the name of any such member will not affect the validity of the notice and demand as to the other members); and any levy, any notice of a lien, or any other proceeding to collect the amount of any assessment, after the assessment has been made, will name the corporation from which such collection is to be made. The provisions of this paragraph shall apply whether or not a consolidated return is made for any subsequent year, and whether or not one or more subsidiaries have become or have ceased to be members of the group at any time. Notwithstanding the provisions of this paragraph, the district director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself.